

U.S. ECONOMIC & INTEREST RATE OUTLOOK

IN THIS ISSUE

• Wages Wake Up

Months of unemployment readings at or below 4% have been encouraging for the domestic economy. At this stage, opportunities outnumber job seekers, and a record number of workers are quitting their jobs for better ones. The labor market is performing as well as it can.

Economic observers have been puzzled by wage growth that has remained tepid despite low unemployment. But last week's jobs report included hourly wage growth of 2.9%, the highest growth rate observed since 2009. As we have observed before, the Phillips Curve may have been dormant, but it is not dead.

During the balance of the year, we expect to see firm inflation, continued strong economic growth and two more Fed rate hikes, followed by slower growth in all respects in 2019.

Key Economic Indicators

	2018				2019				Q4 to Q4 change			Annual change		
	18:1a	18:2a	18:3f	18:4f	19:1f	19:2f	19:3f	19:4f	2017a	2018f	2019f	2017a	2018f	2019f
Real Gross Domestic Product (% change, SAAR)	2.2	4.2	3.4	2.7	2.3	2.0	1.7	1.5	2.6	3.1	1.9	2.2	2.9	2.4
Consumer Price Index (% change, annualized)	3.5	2.9	2.5	2.3	2.3	2.2	2.2	2.2	2.1	2.5	2.2	2.1	2.5	2.3
Civilian Unemployment Rate (% average)	4.1	3.9	3.8	3.7	3.5	3.5	3.5	3.5				4.4*	3.9*	3.5*
Federal Funds rate	1.40	1.67	1.92	2.17	2.42	2.67	2.88	2.88				1.00*	1.66*	2.71*
2-yr. Treasury Note	2.16	2.47	2.61	2.70	2.85	3.05	3.17	3.17				1.40*	2.42*	3.06*
10-yr. Treasury Note	2.76	2.92	2.95	3.10	3.30	3.50	3.65	3.65				2.33*	2.88*	3.53*

a=actual
f=forecast
*=annual average

Influences on the Forecast

- The second estimate of real gross domestic product (GDP) for the second quarter showed annualized growth of 4.2%, a slight upward revision. Consumer spending was revised down slightly, but offset by higher business spending. We continue to expect this will be the strongest growth reading of the year, as transient boosts of front-loaded export orders will not continue supporting GDP in future quarters.
- Consumer measures remain strong, as evidenced by a 5.3% year-over-year gain in disposable personal income in July. As wages rise and tax reform continues to provide a short-term stimulus, we expect consumer spending to lead the way to two more quarters of strong growth in 2018.
- Unemployment remained low in August, unchanged from July's 3.9% rate. Particular improvement was observed in the underemployment (U-6) rate, which includes

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discouraged job seekers and those who are working part-time but would prefer to work full-time. The U-6 reading of 7.4% is the lowest level seen since 2001.

- Inflation has continued to rise, with the consumer price index (CPI) showing growth of 2.9% year-over-year in July, falling slightly to 2.7% in August. The deflator on personal consumption expenditures (PCE) grew by 2.3%, with core PCE (excluding food and energy) reaching 2.0%, the target rate of inflation set by the Federal Reserve. Though wage growth is encouraging, it is only keeping pace with inflation.
- Businesses are feeling inflation pressure, as well. The producer price index (PPI) for finished goods remains elevated, at 3.6% year-over-year in August, on the heels a six-year high of 4.2% in July.
- Oil ended August near \$70 per barrel (WTI), continuing the firm price trend observed throughout 2018. The global oil supply has been curtailed by declining production in Venezuela and restrictions on Iran's ability to conduct international trade due to sanctions. Meanwhile, global demand remains strong. Oil prices are likely to remain at this level.
- Payrolls increased by 201,000 in August, in line with the year-to-date average of 207,000 in 2018, a strong rate of job creation for being this far into an economic growth cycle.
- The housing market remains a soft spot in economic activity. Housing starts rose slightly in July to a seasonally adjusted pace of 1.168 million units. However, this follows a 12.9% decline in June and puts development on a slower full-year pace than was observed in 2017. Wildfires have halted new construction in the West. Mortgage purchase applications fell an average of 2.1% each week in August.
- Comments shared at the Federal Reserve's annual Jackson Hole symposium affirmed that gradual rate hikes are the correct course for current economic circumstances. In light of the on-target inflation reading and low unemployment, we expect to see another 25 basis point rate increase to the federal funds rate at the next Federal Open Market Committee meeting on September 26. Absent any changes to the macroeconomic environment, the Fed will be on track to raise rates further at its December, March, and June meetings, leveling off thereafter.

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